Testimony to the Public Employee Post-Employment Benefits Commission

"An Overview of the City of San Diego's Pension 'Crisis': What Happened and Where Are We Now"

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Introduction

Thank you for the invitation to be here today and the opportunity to speak to the Commission.* Issues involving the San Diego City Employees' Retirement System (SDCERS) have been widely reported[1] and intensively investigated.[2] I have been asked to provide you with an overview of what happened and where SDCERS is today.

I became SDCERS' Administrator/CEO in May 2006, well after the following events occurred. Therefore, the historical overview relies exclusively on the three investigation reports listed in End Note 2. And, given that these investigation reports exceed 800 pages, this overview is an abridged one.

The Role of SDCERS

SDCERS is a public employee retirement system established pursuant to the San Diego City Charter for the purpose of administering the City of San Diego's Retirement System. Pursuant to the Charter, SDCERS also administers the retirement systems of the San Diego Unified Port District and the San Diego County Regional Airport Authority. Under the California Constitution, SDCERS' Board of Administration (Board) is vested with sole and exclusive fiduciary responsibility to manage the assets of the system and to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. Neither SDCERS nor its Board has any role in negotiating or establishing retirement benefits. The Board's duty to the system's participants and beneficiaries takes precedence over any other duty.

What Happened

1991: The Change in SDCERS' Actuarial Funding Method. The precedent for SDCERS' funding issues was established in 1991. That year, the City of San Diego increased retirement benefits to its employees but made the increases contingent on the SDCERS Board changing its actuarial method from Entry Age Normal (EAN) to Projected Unit Credit (PUC). While both EAN and PUC are GASB-approved methods, changing to the PUC method at that time had the impact of lowering the City's actuarially required contribution (ARC) to SDCERS. There was no purpose for the change to PUC except to lower the City's ARC.[3]

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1996: Manager's Proposal 1 (MP1). In 1996, SDCERS' then-actuary was revising certain actuarial assumptions that would increase the City's ARC; the City's labor negotiations had resulted in significantly higher benefit obligations to City employees; the recently-adopted PUC funding method had made the City's ARC less predictable; and the City was preparing to bear the expenses associated with hosting the Republican National Convention. These factors led the City to seek a reduction in its ARC payments to SDCERS.[4] In 1996, the City's funding ratio was calculated at 92.3%.[5]

As it had in 1991, the City, in an arrangement known as Manager's Proposal 1 (MP1), conditioned negotiated benefit increases to City employees upon the SDCERS Board agreeing to a new funding formula that reduced the City's contribution rates to SDCERS. This new funding method - "corridor funding" - was not GASB-approved.[6] This placed City and union representatives on the SDCERS Board in an awkward position: both the City and its labor unions supported MP1, but the benefits were dependent on the Board's approval to accept reduced funding from the City to pay for the benefits.[7] After SDCERS' then-actuary, its then-fiduciary counsel and the City's own fiduciary counsel blessed MP1[8], the Board voted to approve it.

2002: Manager's Proposal 2 (MP2). After MP1 was adopted in 1996, City employee retirement benefits were increased, and the City began paying SDCERS an amount less than its ARC. Also, in 2000, the City settled litigation that also increased benefits. These factors, coupled with the investment market downturn in 2000-2002, resulted in the City's funding ratio dropping precipitously. However, MP1 contained a "safeguard" for this eventuality: if a funding ratio drop was significant enough, then a "trigger" would require additional City payments to SDCERS.[9] The trigger was set at a City funding ratio of 82.3%, 10% lower than its funding ratio in 1996.

In 2002, the continuing stock market slide raised serious concern that the 82.3% trigger would indeed be pulled. The economic implications of this to the City were substantial.[10] Again, the City sought a way to avoid a financial hit and, again, the solution included making new City employee benefits explicitly contingent upon SDCERS providing additional funding relief to the City.[11]

In summer 2002, the City proposed a modification to MP1 to lower the "trigger" to 75%. However, SDCERS' then-actuary and then-fiduciary counsel expressed concerns about this proposal, causing it to be revised. Instead of lowering the trigger, the revision provided for an incremental payment schedule once the 82.3% trigger was hit.[12]

After both SDCERS' then-actuary and its then-fiduciary counsel voiced their approval of MP2[13], the SDCERS Board voted to approve it in July 2002.

Under MP2, the City's employer contribution to SDCERS and the valuation assumptions used to determine the funded status of the system were modified. The City's contribution rates were set below the actuarially calculated rates, which increased both the unfunded actuarial accrued liability and future City contribution requirements. In addition, MP2's actuarial assumptions were more aggressive than the best estimates initially recommended by SDCERS' then-actuary, which increased the risk of a negative actuarial experience. This led to increases in actuarial liabilities and increased City contribution rates in the future.[14]

SDCERS' Unfunded Accrued Liability: 1996 – 2003. SDCERS retained Mercer to audit the City's June 30, 2003 actuarial valuation to evaluate the events that occurred between June 30, 1996 (MP1) and June 30, 2003 (MP2). Mercer's audit estimated the impact that various factors had on the City's unfunded liability during that time period. Mercer estimated that approximately 26% of the liability resulted from City-negotiated benefit increases and 18% resulted from City contributions to SDCERS that were less than those determined actuarially. Investment asset performance during this period, which included some of the highest and lowest returns in recent history, accounted for only 7.5% of the unfunded liability.[15]

Observations On How It Happened

1. **The City, not SDCERS, was the "moving force".** On January 18, 2007, Judge Jeffrey B. Barton of the California Superior Court filed a "Statement of Decision, Phase One" in the consolidated litigation relating to the City's pension system. In the Decision's "Chronology of Events," Judge Barton had this to say about how MP1 and MP2 happened:

   > "The evidence is clear that with regard to both MP 1 and MP 2, ***the City was the moving force in creating, lobbying for and implementing the plan to increase retirement benefits while at the same time reducing contributions to a level below that actuarially required.*** The plan at each step was authorized by the City through its highest elected and management personnel. In both 1996 and 2002, the then City managers presented the proposal to couple benefit enhancements with reduced contributions to the City Council and Mayor before raising them with the employee union representatives or SDCERS." (emphasis added)[16]

2. **The City purposely placed the SDCERS Board in the position of approving City employee benefits instead of simply administering them.** Making MP1 and MP2 contingent on actions by the SDCERS Board placed the Board in the middle of the City's labor negotiations. Conditioning a City employee benefit increase on an action by the SDCERS Board compromised the Board's independence and improperly placed SDCERS in the position of approving benefit increases that resulted from the City's labor/management negotiations.[17] Succumbing to a plan sponsor's dictates that were inconsistent with the best interests of SDCERS' financial soundness led subsequent investigations to conclude that those Trustees who voted in favor of MP1 and MP2 violated their fiduciary duty to SDCERS.[18]

3. **A majority of SDCERS Trustees were City employees and member representatives.** SDCERS' Board has thirteen members. During the consideration of both MP1 and MP2 and prior to the enactment of Proposition H in 2004 discussed below, nine of the thirteen members were current or former City employees. The City's Manager, Auditor and Treasurer were represented on the Board, and there were six elected Board members who were also members of the system.[19] That said, some Trustees who were members of the retirement system voted against MP1 and MP2, while some appointed independent Trustees voted in favor of MP1 and MP2.[20]

4. **It happened in broad daylight.** The SDCERS Board meetings where both MP1 and MP2 were discussed and approved took place in open public session and were reported by the media.

5. **It happened with the experts' approval.** Both MP1 and MP2 were approved by the Board's then-actuary and then-fiduciary counsel.

Three Lessons Learned

As a non-partisan professional, I've learned three lessons from all of this. (I emphasize again: these lessons are entirely my own.)

Lesson 1. Proper Board governance practices can prevent the problems that occurred in San Diego.

As a former lawyer, financial executive and investment manager, my focus has been working with the SDCERS Board to establish a governance structure to ensure that past SDCERS mistakes can never happen again. I believe that governance structure is in place today.

Even before I arrived at SDCERS, reforms embodied in Proposition H that were passed by San Diego voters in 2004 were already having a positive impact.[21] They included changing the composition of the Board to require that a majority of seven Trustees be professionals with at least fifteen years experience in related fields and with no financial interest in SDCERS. These Trustees are limited to two four-year Board terms. Having a majority of Trustees who have no personal financial interest in the retirement system but who do have relevant professional education and experience is critical.

I believe permitting SDCERS members to serve on the Board is appropriate. I have seen system member Trustees add invaluable insight and leadership to Board discussions.[22] Therefore, recommendations to eliminate system members completely from retirement board service may go too far.

However, no matter how experienced or effective a particular Trustee may be, I also believe the term limits included in Proposition H are appropriate. Limiting Trustee terms allows new energy, ideas and insights to come forward and also prompts a healthy reexamination of Board policies and strategies.

But, most importantly, a Trustee must always put the interests of the system ahead of any other. This is the obligation of a fiduciary, and it must be observed at all times. When the Board's search committee asked me about SDCERS' past problems, my response was that certain former Trustees had forgotten the apostrophe: it's the "San Diego City **Employees'** Retirement System." What I meant was that a Trustee's paramount duty is to the retirement system's members; it is not to the plan sponsor, the taxpayer or the Trustee's employer, labor union or own self-interest. My guiding principle as Administrator has been "remember the apostrophe!"

In addition to the Proposition H reforms and the Board's reconstitution in 2005, there have been numerous recent positive changes at SDCERS, including the hiring of a new actuary, a new fiduciary counsel, a new Administrator/CEO, a new General Counsel, a new Chief Financial Officer and a new Chief Compliance Officer.

In addition, SDCERS' new Board and executive staff have worked together to improve SDCERS' governance, actuarial soundness and tax compliance. Examples include:

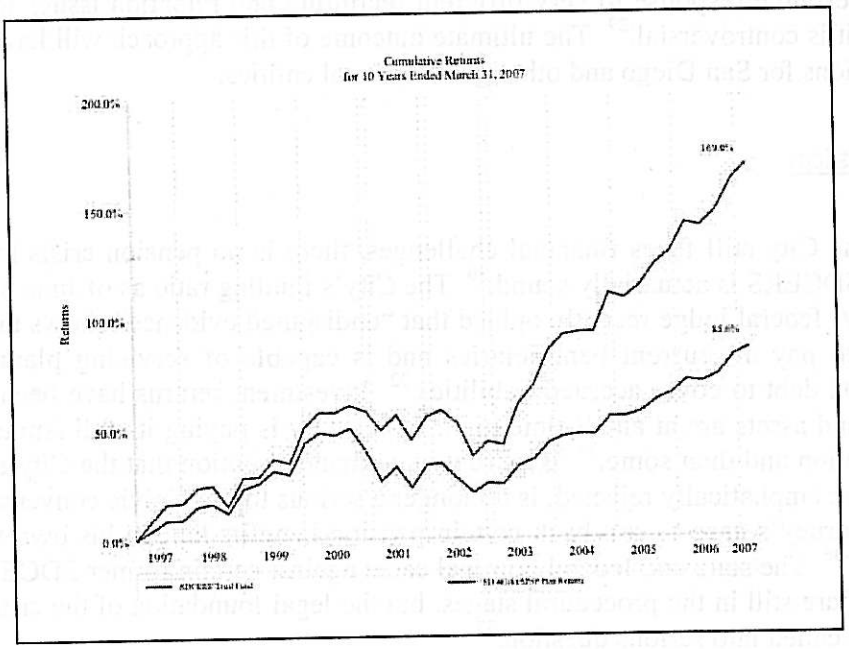
- Commissioning the independent Navigant Consulting Report and convening an ad hoc committee of the Board to address the Report's recommendations;
- Creating a truly independent Audit Committee with a majority of independent, non-Board members;
- Creating an Internal Audit position that reports directly to the Audit Committee;
- Commissioning an Actuarial Funding Study that reviewed SDCERS' actuarial methods and assumptions and that resulted in the adoption of more conservative and widely-accepted methods and assumptions;
- Applying to the IRS for a Tax Determination Letter to confirm SDCERS' status as a tax-qualified governmental retirement plan; and
- Entering into the IRS' Voluntary Correction Program to work cooperatively to resolve past mistakes in administering the Trust Fund.

Lesson 2. San Diego's trials (literally) and tribulations should not be used to support an attack on defined benefit plans in general.

Blaming San Diego's pension problems on the defined benefit plan structure is like blaming a pen or pencil for a misspelled word.[23] Defined benefit plans provide employers, employees and retirees with significant advantages over defined contribution plans.[24]

A recent study that criticized the defined benefit plan of the Ohio State Teachers Retirement System advocated for a move to a defined contribution or hybrid plan. A spokesman for the study summed it up this way: "It's saying to people: 'You have to make decisions yourself. Here are some mutual fund options.'"[25] Unfortunately, this facile philosophy ignores investment reality. Studies show that individual investors, for a host of reasons, under perform the market.[26]

Let me provide a powerful San Diego example. As SDCERS' Administrator, I sit on the board that oversees the City's 401(k) and Supplemental Pension Savings Plan, both of which embody the traditional elements of a defined contribution (DC) plan. The graph below shows the returns based on the actual asset allocation of the two City DC plans beginning in the third quarter of 1997 through the first quarter of 2007 compared to SDCERS' actual investment performance during the same time period.[27]



This comparison illustrates the significantly lower investment returns realized by most San Diego City employees in a defined contribution plan as compared to the returns generated by the professional money managers retained by SDCERS. ($10,000 invested in 1997 in the two City DC plans would be worth approximately $18,600 as of March 31, 2007 compared to $26,900 if invested during the same time period by SDCERS.) This significant differential in returns has a significant impact on an employee's retirement financial security.

Given a choice, I think everyone would prefer to participate in a defined benefit plan. Why? Because, in addition to superior investment performance, defined benefit plans also provide guaranteed lifetime income and survivor and disability protections.

Lesson 3. Fundamental human resource management principles that provide the foundation for private sector compensation practices should play a more prominent part in public sector compensation decisions.

It is axiomatic in the private sector that compensation systems should be designed to recruit, retain and motivate employees.[28] Yet, in both 1996 and 2002, San Diego provided its employees with significant benefit enhancements for politically expedient reasons having little or no relation to whether the benefit enhancements were necessary to recruit or retain employees. When benefit increases are implemented primarily for political purposes, they undermine the foundations of principled compensation decision making.

San Diego's Mayor recently took steps more in line with this approach by decoupling police and fire employee compensation packages. While this seems like a textbook human resource response to very different recruiting and retention issues for these two groups, it is controversial.[29] The ultimate outcome of this approach will have significant implications for San Diego and other governmental entities.

Conclusion

While the City still faces financial challenges, there is no pension crisis in San Diego today. SDCERS is actuarially sound.[30] The City's funding ratio as of June 30, 2006 was 80%.[31] A federal judge recently opined that "undisputed evidence" shows that SDCERS is able to pay all current beneficiaries and is capable of servicing planned pension obligation debt to cover accrued liabilities.[32] Investment returns have been stellar, and Trust Fund assets are at an all-time high.[33] The City is paying its full Annual Required Contribution and then some.[34] Bankruptcy, a financial option that the City's Mayor and CFO have emphatically rejected, is no longer a serious topic of civic conversation.[35] The City Attorney's case to roll back certain pension benefits has, in his own words, been "gutted."[36] The state and federal criminal cases against certain former SDCERS Trustees and staff are still in the procedural stages, but the legal foundation of the criminal claims has been called into serious question.[37]

During the past two years, SDCERS has opened its doors to investigators, auditors, media, stakeholders and the public. The new Board has studied SDCERS' recent past and implemented meaningful change to ensure that these problems won't recur. The real pension story in San Diego today is SDCERS' proactive solutions to its past problems that should serve as the standard for public pension plan governance across the country.

End Notes

1 For press reports, see, the San Diego Union-Tribune's coverage at www.signonsandiego.com/news/metro/pension/. See also Mary Williams Walsh, "Some Cities Struggling to Keep Pension Promises," NY Times (May 5, 2004); John M. Broder, "Sunny San Diego Finds Itself Being Viewed as a Kind of Enron-by-the-Sea," NY Times (Sept. 7, 2004); Elliot Spagat, Pension woes put San Diego on brink," The Boston Globe, (October 13, 2004); Judy Ward, "Their Own Worst Enemy," Plan Sponsor magazine (September 19, 2005); Mary Williams Walsh, "Public Pension Plans Face Billions in Shortages," NY Times (August 9, 2006).

2 For results of investigations, see Vinson & Elkin's "Report on Investigation," (September 16, 2004) ("V&E"); Navigant Consulting, Inc.'s "Investigation for the Board of Administration of the San Diego City Employees' Retirement System," (January 20, 2006) ("Navigant"); and Kroll, Inc. and Willkie Farr & Gallagher's "Report of the Audit Committee of the City of San Diego," (August 8, 2006) ("Kroll"). The U.S. Securities and Exchange Commission entered an order sanctioning the City for committing securities fraud by failing to disclose material information about its pension and retiree health care obligations in the sale of municipal bonds in 2002 and 2003. See SEC Administrative Proceeding No. 33-8751 (November 14, 2006).

3 V&E at 39, Navigant at 32 and Kroll at 34-35.

4 V&E at 41-43, Navigant at 36 and Kroll at 36-37.

5 V&E at 45 and Kroll at 41.

6 V&E at 47.

7 V&E at 45, 51-52, 61, Navigant at 35 and Kroll at 42.

8 V&E at 47-48, Navigant at 34, 47-50 and Kroll at 42.

9 V&E at 45-47, Navigant at 66 and Kroll at 59-66.

10 V&E at 80-81 and Kroll at 65-66.

11 V&E at 82 and Navigant at 66.

12 V&E at 84-95 and Kroll at 74-77.

13 V&E at 92 and Kroll at 76.

14 Mercer Audit of Actuarial Work (May 11, 2004) at 6.

[15] Mercer, Audit of Actuarial Work (May 11, 2004) at pp. 43-47. Other causes of the unfunded liability included the use of reserves for additional benefits (30%), actuarial assumption changes (5%) and non-asset experience (14%).

[16] San Diego Superior Court Case No. GIC841845, filed January 18, 2007, at 7-8.

[17] V&E at 40 and 95, Navigant at 31 and Kroll at 35. SDCERS also reset the City's amortization period to 30 years, the maximum allowed.

[18] Navigant's Legal Analysis (prepared by Reish Luftman Reicher & Cohen) at 9 and Kroll at 97, 101.

[19] Navigant at 22.

[20] SDCERS Board minutes.

[21] Surprisingly, two of the public figures most identified with pension reform in San Diego argued against Proposition H, saying that it "does nothing" to solve SDCERS' underfunding or management problems. Recent history has proved their arguments wide of the mark.

[22] Two examples of outstanding Board leadership by system members in San Diego are Steve Meyer and Mark Sullivan. Mr. Meyer, SDCERS' former Board Vice-President, serves as Chair of the Investment Committee, and Mr. Sullivan, SDCERS' current Board Vice President, chaired the Board's ad-hoc Navigant Report Committee that recommended many of the "best practice" Board governance policies that the Board has implemented.

[23] Larry the Cable Guy.

[24] See, for example, Waring and Siegel, "Don't Kill the Golden Goose: Why DB retirement plans can and should be saved, and how to do so," Financial Analysts Journal (January/February 2007) and "Wake Up and Smell the Coffee!: DC plans aren't working. Here's how to fix them." Investment Insights, Barclays Global Investors (June 2006, Vol. 9, Issue 3).

[25] FundFire, "Ohio Teachers Fund Slammed by Think Tank," (June 13, 2007).

[26] See DALBAR, Inc., "Quantitative Analysis of Investor Behavior 2006" at p.6. ("The past twenty years have been, overall, a boon to the mutual fund industry. Major market indices, the S&P 500 and Aggregate Bond Index, have posted impressive returns. Yet the average investor has earned only a fraction of these results.") See, also, David F. Swenson, "Invest at Your Own Risk," NY Times (October 19, 2005) and Hal R. Varian, "Sometimes the Stock Does Better Than the Investor That Buys the Stock," NY Times (May 3, 2007).

[27] The San Diego 401(k)/SPSP Plan Returns were created using these Plans' total assets and investment manager allocations. Using the provided quarterly allocations, each manager's weighting relative to the total plan was used to create a target to simulate what a total fund return would look like for the Plans.

[28] See, for example, Robert J. Greene, "Managing Direct Compensation," Society for Human Resource Management – Compensation & Benefits Library (April 2003).

Mercer completed a "Best Practices Review Benefits Comparison" for SDCERS in October 2004. Mercer found that the City's service benefit formulas for general and public safety members were generally on par with or greater than that provided by the California and City peer plans, but that this was offset by the fact that the City requires 10 years of service in order to become vested and eligible to receive benefits. "This service requirement is much longer than the more typical 5 years or less for the peer plans. Further, unlike most of the peer plans, SDCERS does not provide retirement eligibility based on service alone (e.g. 30 years of service at any age) or an age and service rule (e.g. age plus service equal to 85)."

For an excellent (and too little discussed) comparison of municipal pension plan provisions, see Kroll's Appendix I.

[29] Tony Manclatos, "Debate on firefighters' pay raise is coming to a head," San Diego Union-Tribune (April 22, 2007) and Jennifer Vigil, "Safety budgets dissected," San Diego Union-Tribune (May 10, 2007).

[30] Joseph Esuchanko, the independent actuary retained by the Mayor to validate the actuarial valuations prepared by SDCERS' actuary and retained by the City Attorney to serve as an expert witness, confirmed that SDCERS was actuarially sound in remarks before the City Council on April 17, 2007.

[31] June 30, 2006 Actuarial Valuation for the City of San Diego.

[32] SDPOA v. Aguirre, et al., U.S. District Court, Southern District of California, Case No. 05-CV-1581 H (POR) at 7.

[33] SDCERS' investment returns as of the end of the June 30, 2007 fiscal year will exceed 15%, well above the actuarially assumed rate of 8%.

As of December 31, 2006, the one-year total return was +14.08% (top 42% of public pension plans); the three-year annualized total return was +12.28% (top 12% of public funds); the five-year period (which spanned a sizable part of the 2000-2002 bear market) annualized return was +11.05% (top 3% of public pension plans); and the ten-year period annualized total return was +10.09% (top 4% of public pension plans).

These investment results were achieved using a well-diversified asset allocation policy that is more conservative than the average public pension plan. That asset allocation strategy is currently 38% in domestic stocks, 17% in international stocks, 30% in domestic fixed income, 4% in non-U.S. fixed income and 11% in real estate.

Investment returns are critically important because they represent over 70% of the amount of retirement benefits paid out by SDCERS.

[34] Public comments and commitments by the City's Mayor and CFO.

[35] Public comments by the City's Mayor and comments to the City Council by the City's CFO on April 17, 2007. Indeed, bankruptcy was never considered a serious option by San Diego voters, either. In 2004, the pro-bankruptcy Mayoral candidate received only 2.3% of the vote.

[36] Petition for Review filed by the City Attorney in the California Supreme Court, dated March 23, 2007 at 1.

[37] Kelly Thornton, "Concerns of judge strike at U.S. case," San Diego Union-Tribune (December 14, 2006) and Greg Moran, "Rulings hinder once-swift pace of pension battle," San Diego Union-Tribune (December 16, 2007).